FACTSHEET ON DIGITAL ECONOMIES AND ILLICIT FINANCIAL FLOWS

Introduction

- The emergence of illicit financial flows has become a topical issue in recent years. In the African continent, illicit financial flows have drawn a lot of attention because they have resulted in domestic revenue losses that African governments desperately need to sustainably and predictably fund their development.
- Illicit financial flows occur when money is illegally earned, transferred or spent with the intention that this money disappears from fiscal and trade records in the country of origin.
- Key characteristics of IFFs: the transfer of the funds itself is illegal, the funds are proceeds of illegal activities, if legal obligations relating to legal commercial activities such as payment of taxes have not been observed.
- In a context where new digital technologies for money transfers, such as online and mobile banking, electronic payments, crypto-currencies, e-commerce providers, and online gambling services have evolved, it is important to interrogate the extent to which digital economies facilitate IFFs or can be used as a tool to fight IFFs.

What are Digital Economies?

Digital economy is the global network of economic and social activities that are enabled by platforms such as the Internet, mobile and sensor networks.[1]

The concept of digital economy is evolving, multifaceted and dynamic in nature due to the transformational power of digital technologies.[2]

According to OECD, the digital economy enables and executes the trade of goods and services through electronic commerce on the internet.[3]

Digital vs Traditional Economy

- Digital technologies allow firms to do their business differently as well as more efficiently and cost effectively
- Digital economy give rise to entirely new market structures that remove transaction costs in traditional markets
- Digital economy generates enormous amounts of data. It is different from traditional purchases in a brick and mortar store using cash which is sometimes time consuming.

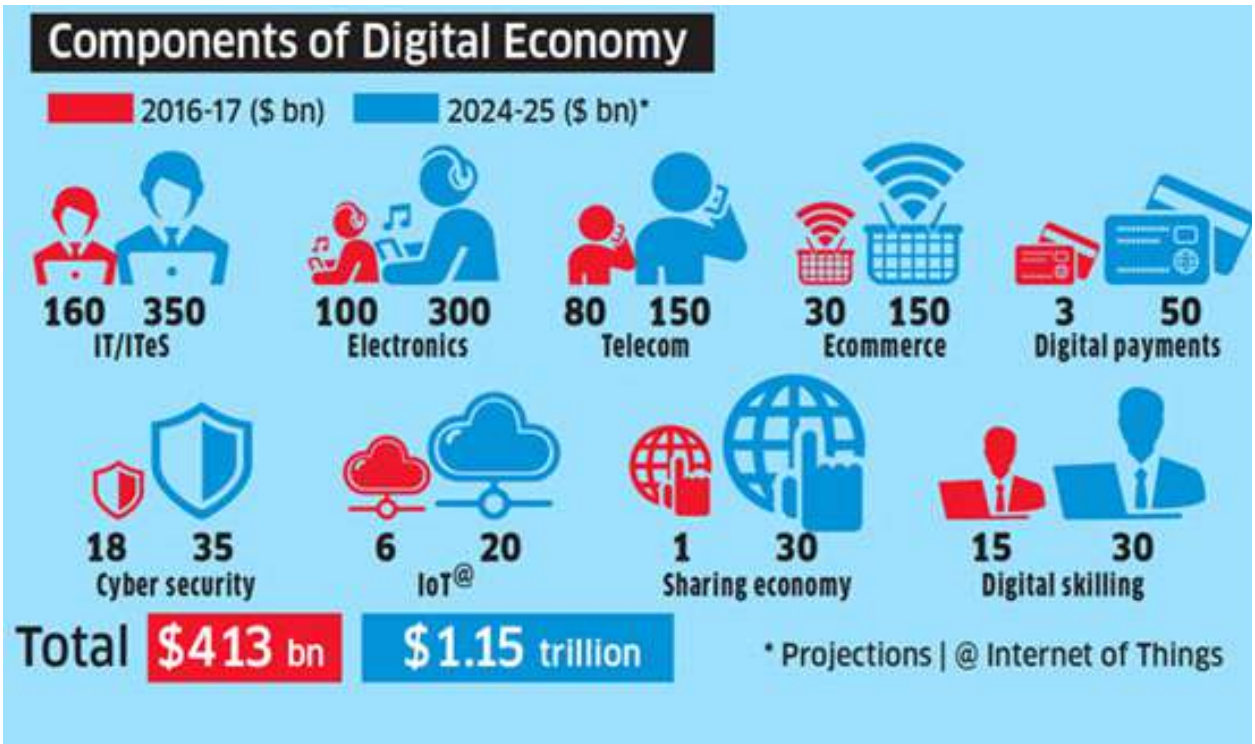
What drives the digital economy?

- *Content production* – creating content for websites, applications, websites and social media pages
- *Consumption* – new goods and ever-changing tastes and preferences
- *Indexation*- connection of prices and asset values by businesses

Components of digital economy

The components of digital economy include:

- **E-commerce** - covers goods and services sold and bought online, including transactions via platform-based companies such as ride-hailing apps, reflected under business-to-consumer (B2C) revenue reported by the transportation sector, and room-sharing platforms reported under accommodation. The global value of e-commerce is estimated by UNCTAD to have reached $29 trillion by 2017[4]
- **Digital payments** - Digital payment is a way of payment which is made through digital modes. In digital payments, payer and payee both use digital modes to send and receive money. It is also called electronic payment.[5]
- **Cyber security** - Cyber security refers to the body of technologies, processes, and practices designed to protect networks, devices, programs, and data from attack, damage, or unauthorized access. Cyber security may also be referred to as information technology security.[6]
- **Telecommunication** - Telecommunications, also known as telecom, is the exchange of information over significant distances by electronic means and refers to all types of voice, data and video transmission. This is a broad term that includes a wide range of information transmitting technologies such as telephones (wired and wireless), microwave communications, fiber optics, satellites, radio and television broadcasting, the internet and telegraphs.[7]



Source: http://panconfifftax.net/wp-content/uploads/2019/09/PAC-2019.-Illicit-Financial-Flows-and-the-Digital-Economy-copy.pdf

- The picture compares these components for the period 2016-17 (in red) and the period 2024-25 (in blue)
- By the year 2025 the digital economy globally is expected to be around $1.15 trillion from around $413 billion in 2017

Size of Digital economies

- Measuring the size of digital economies is difficult because reliable statistics on the key components and dimensions of digital economies, especially in developing countries, are lacking.
- Depending on the definition, estimates of the size of the digital economy range from 4.5 to 15.5 per cent of world GDP.[8]

Digital tools that facilitate IFFs

- Online banking
- Mobile banking
- Electronic payment systems via unregulated financial intermediaries
- Online services
- Trading platforms
- Online gambling
- Cryptocurrencies

Taxing the digital economy in Africa

- The spread of the digital economy poses challenges for international taxation. The major challenges that characterise digital economies in terms of international taxation are:
  - *reliance on intangible assets,*
  - *the massive use of data (notably personal data),*
  - *capturing value from externalities generated by free products, and*
  - *the difficulty of determining the jurisdiction in which value creation occurs.*

- These challenges raise fundamental questions as to how enterprises in the digital economy add value and make their profits, and how the digital economy relates to the concepts of source and residence or the characterisation of income for tax purposes.
- New ways of doing business in digitised economies may result in a relocation of core business functions and, consequently, a different distribution of taxing rights which may lead to low taxation.
- The tax challenges of the digitalisation of the economy were identified years ago, as one of the main areas of focus of the Base Erosion and Profit Shifting (BEPS).
- There is a need for a new set of tax rules at an international level in order to address the tax challenges from digitalization.
- The OECD Pillar One a Unified Approach which will give countries the right to tax profits of international businesses (regardless of whether they have a base in the country or not) based on calculating up to three separate pots of profit has been proposed.[9] The three pots are:
  - Modified Residual Profit Split Method that would allocate to market jurisdictions a portion of an MNE's non-routine profit (which is not recognised under the current profit allocation rules);
  - A Fractional Apportionment Method, allocating profits based on a formula that may consider relevant factors such as employees, assets, sales and users; and
  - Distribution-based approaches that could consider both non-routine and routine profits arising from activities associated with market and distribution.

- This moves away from the long-established principle of "profit where the business has physical presence" which has been the cornerstone of the international framework, and represents arguably the most significant change in the international tax architecture in 100 years.
- Furthermore[10], Pillar Two which is the Global Anti-base Erosion mechanism will help to stop the shifting of profits to low or no-tax jurisdictions facilitated by new technologies; ensure a minimum level of tax is paid by multinational enterprises (MNEs); and levels the playing field between traditional and digital companies.

Digital economies and domestic resources mobilisation

- Digital economies have the potential to increase domestic resources that countries can mobilise.
- Countries may collect taxes from the following digital service – telecommunications services providers, The internet service providers, digital operators (Facebook, twitter), Equipment manufacturers, terminal manufacturers (apple, Samsung) and content providers.
- The following taxes cab be imposed on digital goods and services – wireless services (VAT on monthly bills), Broadband (internet access taxes, VAT on broadband subscriptions) International long distance (VAT), PCs, tablets (VAT, customs duty), Digital content (VAT on digital goods) Electronic commerce (Vat on physical products bought through a digital channel).

How are African countries taxing the digital economies?

- Uganda- in July 2018 Uganda imposed a 0.5% social media tax for using mobile applications and social media sites like WhatsApp and Facebook.[11]
- Zambia- in introduced 5% tax on internet voice calls
- Benin- introduced a 0.5% per megabyte tax of data on applications like Facebook, twitter, Skype, Instagram
- Nigeria- 5% tax on goods bought on line
- Tunisia the mobile market revenue accounted for 2.2% of GDP, the sector's tax and fee payments accounted for around 3.4% of government total tax revenue.[12]

Do digital economies facilitate IFFs?

- The anonymous nature of the internet and innovations in technology can provide criminals with multiple ways to launder illegally acquired money through covert, anonymous, and even seemingly legitimate online transactions.
- Digital technologies can potentially facilitate IFFs at three stages.

Do Digital economies facilitate IFFs

Earning	Transfers	Use
• Digital underground economy: cybercrime and "crime as a service" • Migration of traditional organized crime online • Embezzlement and fraud in the telecom sector	• Online and mobile banking: slicing and automation of transactions • Electronic payments via unregulated intermediaries • Digital/ crypto currencies : ensuring anonymity • E-commerce: manipulation of supply of goods • Online gambling/online betting	• Offshore electronic bank and investment accounts • Fake e-commerce companies • Offshore online casinos • Terrorist financing

Source: Tropina (2016)

African countries are losing revenues through digital economies

According to the Africa cyber security report (2017) cybercrimes have cost African businesses $3.5 Billion.

South Africa

The South Africa Post Office was also hacked and it lost close to R42 million Rands. In 2013 South Africa lost R5.8billion which is 0.114%of the country's GDP to cyber

Zimbabwe

According to the reports of Reserve Bank of Zimbabwe (RBZ, 2015), cybercrime is a major contributor to the estimated US$1, 8 billion illegitimate earnings generated from criminal actions executed yearly in Zimbabwe.

Uganda and Tanzania

It is estimated that annually $1.078 billion is lost through fraud and theft of credit cards details.

kenya

In 2013, an estimated $36 million (0.05% of GDP) was lost to cybercrime. In 2015 the loses rose to $150 million.

Nigeria

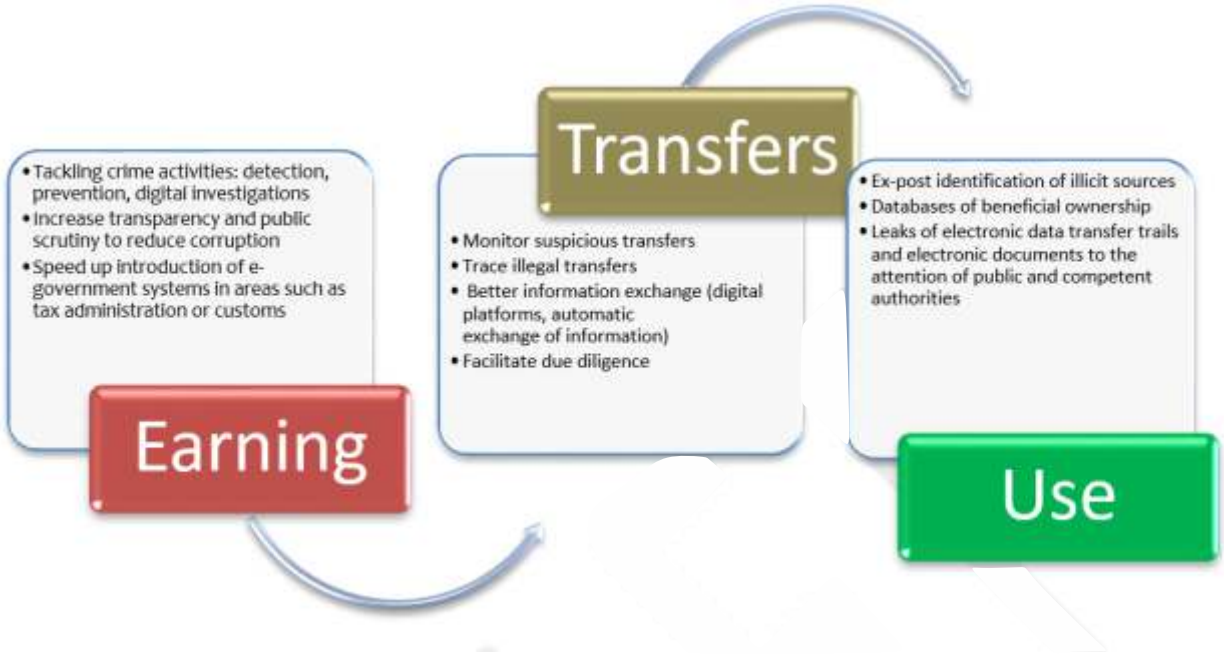
Failure to migrate to digital economy costs **Nigeria** $6b yearly.[13]

Tunisia

Tunisia - lost $3.5 million in tax revenues in the digital economy sector in 2016.[14]

How digital technologies can be used to curb illicit financial flows?

- Digital technologies can be used in tracking crime activities, investigation and detection across the stages of illicit activates through remote software forensic



Recommendations to African governments

- Governments should set up institutions that can respond/adapt to quickly changing landscape, respond in terms of policy and strategy and provide ways through which they can benefit from technological advancements. This will involve harmonizing legal frameworks that govern digital economies and those that curb IFFs.
- There is need for the crafting and implementing policies to make digital economy benefit the everyone not only just a few. Governments and stakeholder should shape the digital economy by defining the rules that are fair to every country. This will involve building consensus on establishing mechanisms for international cooperation and mutual legal assistance.
- African countries should enhance their readiness to create and capture value created by digital economies. Countries should identify areas for improvement and policy interventions that could help alleviate bottlenecks.
- There is need for awareness raising on the potential dangers and benefits of digital economies. This awareness raising process should start with knowledge generation on the link between digital economies and tax, the size of Africa's digital economy.
- Revenue from digital taxation should be allocated to resourcing technology including skills building in schools, acquiring and building state of the art satellites and broadband networks thus ensuring that no one is left behind. For Africa to effectively harness revenue from the digital economy it is important for governments not to discourage digital platforms through excessive taxation thus fair and effective ways of taxing the digital economy should be put in place.

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